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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR AN ORDER OR ORDERS AUTHORIZING IT TO ISSUE, INCUR, OR ASSUME EVIDENCES OF LONG-TERM INDEBTEDNESS; TO ACQUIRE A FINANCIAL INTEREST OR INTERESTS IN AN AFFILIATE OR AFFILIATES; TO LEND MONEY TO AN AFFILIATES OR AFFILIATES; AND TO GUARANTEE THE OBLIGATIONS OF AN AFFILIATE OR AFFILIATES.	Docket No. E-01345A-02-0707

Arizona Corporation Commission
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RUCO's INITIAL CLOSING BRIEF

The Residential Utility Consumer Office ("RUCO") hereby files its Initial Closing Brief in this matter. RUCO supports approval of Arizona Public Service Company's ("APS" or "Applicant") financing request, with appropriate conditions.

Introduction

The Arizona Corporation Commission enacted its Electric Competition Rules (R14-2-1601 to 1616) in 1996, and revised them in 1999. As revised, those rules required that competitive electric generation assets be separated from a regulated utility prior to January 1, 2001, and that after that date, the utility purchase power for Standard Offer service from the competitive market, with at least 50 percent through a competitive bid process. In Decision No. 61973 (October 6, 1999), the Commission approved a Settlement Agreement between APS and several parties. The Settlement Agreement extended the January 1, 2001 deadline for APS to divest generation and begin acquiring power from the competitive market to January 1, 2003. The Settlement Agreement also approved the transfer of APS's generation assets to a then-unformed affiliate, which later became Pinnacle West Energy Corporation ("PWEC").[1]

Subsequent to Decision No. 61973, PWEC began construction of additional generation plants. Construction of those plants was financed by bridge debt issued by the parent company Pinnacle West Capital Corporation ("PWCC"). Exh. APS-1 at 8 (Gomez). Virtually all of that debt will mature by February 2004, with the bulk of it in mid-2003. Exh. APS-1 at 8. PWEC secured an investment-grade debt rating, conditioned on its acquisition of the APS generation assets. Exh. APS-1 at 6 and Schedule BMG-1. PWEC intended to refinance the bridge debt after the transfer of the generation assets from APS. Exh. APS-3 at 6 (Tildesley).

In Decision No. 65154 (September 10, 2002), the Commission recognized that circumstances had changed since the Competition Rules and the Settlement Agreement were adopted. Arizona's wholesale electric market was not workably competitive, was poorly structured and was susceptible to possible malfunction and manipulation. Decision No. 65154 at 28-29, Finding of Fact Nos. 16, 25. To protect customers from the risks posed by the dysfunctional wholesale market, the Commission instructed APS to cancel

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[1] Additionally, the Settlement Agreement provided for an adjustment clause to begin in 2004 by which APS could recover a portion of the costs to implement the Electric Competition Rules.

divestiture its generating assets to PWEC, and stayed the requirement that APS (and others) obtain power for standard offer customers from the competitive market. Id. at 32-33. The Commission invited APS to file an application to consider whether APS should acquire the PWEC generation assets. Id. at 26, 32-33.

In its application in this proceeding, APS seeks authority to issue $500 million of long term debt, the proceeds of which it would loan to its affiliate PWEC or APS's parent PWCC to support the long term financing of PWEC's generation assets. In the alternative, APS requests authority to guarantee PWEC's or PWCC's issuance of $500 million long term debt to support the PWEC generation assets.

Analysis

Arizona Revised Statutes § 40-301(C) sets forth the minimum requirements that the Commission must find to authorize APS's issuance of additional debt. A.R.S. § 40-301(C) provides that the Commission shall not grant approval of a debt issuance unless it finds that the issuance is:

> for lawful purposes which are within the corporate powers of the applicant, are compatible with the public interest, with sound financial practices, and within the proper performance by the applicant of service as a public service corporation and will not impair its ability to perform that service.

In addition, A.A.C. R14-2-804 prohibits APS from loaning the proceeds of any such debt issuance to its affiliates PWEC or PWCC, unless the Commission grants prior approval. A.A.C. R14-2-804(C) provides the standard under which the Commission must evaluate the request to make a loan to an affiliate:

> The Commission will review the transaction...to determine if the transaction would impair the financial status of the public utility, otherwise prevent it from attracting capital at fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable and adequate service.

Compatible with performance of public service obligations

Much of the controversy over the application focuses on whether the proposed financing is within the proper performance of APS's service as a public service corporation. If PWEC were a stand-alone merchant generator whose venture failed and went bankrupt, APS would not be concerned. Exh. RUCO-1 at 7 (Diaz Cortez). However, APS's credit rating, and thus its cost of capital in its upcoming rate case, is impacted to some degree by the success of its affiliate PWEC. Therefore, APS's financing of PWEC generation assets can be within the scope of its utility services.

PWCC cannot continue to carry all the debt to finance the PWEC generation without a high risk of downgrading. Exh. APS-1 at 10 (Gomez); Tr. at 90-91 (Gomez discussing impact of the Panda proposal that PWCC refinance the debt). Two ratings agencies have publicly declared that a downgrade is imminent absent refinancing at APS. Moody's, in a September 9, 2002 Opinion Update, stated "The rating outlook is stable and assumes that the Pinnacle bridge financing is refinanced at an operating subsidiary in the intermediate term. Failure to do so could have negative rating implications." Exh. APS-6 at 2. Ms. Gomez testified that, in the lingo of ratings agencies, "could" means "would", and that APS is the only PWCC operating subsidiary to which Moody's could be referring. Tr. at 296-7. Fitch has also stated that a failure to obtain an inter-company loan or some other source of funding would result in a downgrade of PWCC. Exh. APS-2 at Schedule BMG-2R. Ms. Gomez testified that it is impossible for PWEC to obtain a $500 million loan itself using the generation assets as collateral. Tr. at 202. Therefore, the only way to stave off downgrades by Moody's and Fitch is to refinance the bridge debt at APS.

Avoiding PWCC's downgrade is not enough reason to permit APS to issue $500 million in debt. However, PWCC's downgrade could harm APS's own credit ratings. Ms. Gomez testified that, as a result of her conversations with ratings agencies, she is confident that a downgrade of PWCC would roll down onto APS, resulting in a downgrade of the utility's debt ratings. Tr. at 91, 298. Ms. Gomez explained that Standard & Poors, and to some degree other rating agencies too, look to the entire enterprise when establishing credit ratings for the individual entities within that enterprise. Exh. APS-1 at 12. Therefore, any decline in PWCC's creditworthiness would be reflected in their evaluation of APS. Exh. APS-1 at 12. Lenders would extract higher capital costs from APS based on adverse circumstances faced by PWCC. Exh. APS-1 at 12. Staff witness Thorton agreed that a decline in PWCC's credit rating could drag down APS's credit rating as well. Exh. S-1 at 4, 5; Tr. at 910-912. Therefore, because APS will use the borrowed funds to protect its own credit rating, the financing is within the proper performance of APS's duties as a public service corporation.

Not impair APS's ability to perform its public service obligations

APS's issuance of $500 million in debt will not impair its ability to perform its public service obligations. Moody's noted in its December 30, 2002 Opinion Update on APS that "while APS's coverages may decline if the financing application is approved, the resulting credit metrics should remain consistent with the current rating..." Exh. APS-5 at 4. In addition Standard & Poors concluded that "[e]ven on a stand-alone basis, APS' financial health remains solidly within the triple-'B' category even with the addition of $500 million in debt." Exh. S-4 at 1. *See also* Tr. at 91 (Gomez).

Compatible with the public interest

In addition to being compatible with APS's performance of its public service and not impairing that ability, the financing is compatible with the public interest (subject to conditions discussed below). APS must remain sound financially to serve the public, notwithstanding any financial impairment of PWEC or PWCC. Exh. RUCO-1 at 8. The Commission should not stand aside and watch PWEC collapse (to the detriment of APS) and attempt to clean up the wreckage afterward when it can proactively prevent PWEC's financial collapse. *Id.* (RUCO-1 at 8).

Further, granting the Application will allow PWEC/APS to maintain the generation assets, to the benefit of APS customers. If the application were denied, PWEC would have to consider selling off its generation assets. Tr. at 227 (Gomez). If PWEC were to sell off the generation assets, for perhaps pennies on the dollar, APS customers may no longer have access to the power they produce. The PWEC assets are not necessarily uneconomic for all time, however. They could become economic in the future, and should be preserved for the benefit of APS customers, rather than sold off to the highest bidder who may not make their output available to Arizona electric customers. Exh. RUCO-1 at 8.

Compatible with sound financial practices

Generally, a utility issuing debt to finance assets owned by an affiliate is not compatible with sound financial practices. Exh. S-1 at 4 (Thorton); Tr. at 839-840 (Diaz Cortez). Sound financial principles would normally require the debt and the assets financed by that debt to be held by the same enterprise. Exh. S-1 at 6 (Thorton). Even APS agrees. Exh. APS-2 at 9 (Gomez).

However, RUCO and Staff each propose conditions that would make the application consistent with sound financial practices. RUCO proposes that APS be required to file an application with the Commission within 45 days to transfer the PWEC generation assets to APS. Exh. RUCO-1 at 12; Tr. at 839-840. Staff proposes that APS obtain a security interest in the PWEC generation assets. Exh. S-1 at 11. Both proposed conditions address the risk that a default by PWEC or PWCC on its note to APS would leave APS with no assets and no recourse against any assets. While the transfer of ownership is a more direct way to address the disconnect between obligations and ownership, the Staff-proposed security interest in the assets would serve as a necessary minimum protection. If the Commission adopts RUCO's condition, however, Staff's condition to require a security interest becomes moot. Tr. at 840-842 (Diaz Cortez).

Further action is necessary

Granting the APS application is merely a stopgap measure to prevent PWCC from defaulting on its short-term debt obligations and going into bankruptcy. It is not a complete solution to insulate customers from the impacts of dysfunctional energy markets. RUCO-1 at 10 (Diaz Cortez); Tr. at 981 (Thorton). A cohesive comprehensive plan to rebuild the regulatory paradigm is necessary to return the electric industry in Arizona to functional viability. Exh. RUCO-1 at 10. It is important to rebuild the electric industry framework sooner rather than later, because transition costs will continue to accrue as long as the Commission's plans to restructure remain unsettled. Addressing the damages caused by failed competitive markets a step at a time impedes the necessary rebuilding of the regulatory framework, and in the end, costs customers more. *Id.* at 11-12.

RUCO proposes that, in the upcoming APS rate case, to be filed in June 2003, the Commission consider the degree to which the PWEC assets (to be transferred to APS per RUCO's other proposed condition) should be included in APS's rate base. Exh. RUCO-1 at 12-13. In addition, the rate case can determine the transition costs incurred, and an appropriate allocation of those costs. Further, RUCO recognizes that the Electric Competition Rules should be revised consistent with the reconstructed regulatory framework. The Commission's instruction to Staff in Decision No. 65154 to examine such changes is an appropriate avenue for such examination.

Conclusion

APS's proposed financing to support the PWEC assets, with appropriate conditions, protects APS's credit rating and is in the public interest. In approving the application, the Commission should require that APS file within 45 days an application to transfer the PWEC generation to APS, and should consider in the upcoming rate case the extent to which those assets should be included in APS's rate base.

The costs to transition to a restructured electric industry continue to accrue. To minimize those costs, the Commission should not delay its rebuilding of the industry.

RESPECTFULLY SUBMITTED this 27th day of January, 2003.

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